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## Japan Prepares For Consumption Tax

In early April the minds -- if not the hearts -- of young and old alike in America turn to taxes. This year Japanese taxpayers will do their U.S. counterparts one better as they brace for the introduction of a 3 percent consumption tax that promises to change the price of practically everything a Japanese consumer purchases (see JEI Report No. 45B, December 2, 1988). Just as American bookstores are inevitably full of tax guides in the spring, Japanese bookstores have reported brisk sales of books explaining the new consumption tax; three out of the 10 most popular nonfiction titles deal with the subject. Almost in sync with the cherry blossoms for which Japan is famous, the new system will burst into bloom April 1 after months of preparation.

For some the new system will be as welcome as the cherry blossoms, only longer lasting. On products for which the new 3 percent consumption tax replaces a commodity tax, prices will drop substantially. Most prominent among these goods are cars. All the major manufacturers have announced hefty price reductions. Toyota Motor Corp., Honda Motor Co., Ltd. and Mitsubishi Motors

With firms worrying they will have to absorb the tax and consumers fearing unfair price increases, the Japan Fair Trade Commission has found itself in the middle. On the one hand, it has approved hundreds of cartels for manufacturers and distributors to help them adjust to the new system, suggesting a tilt toward higher prices. On the other hand, it also has said it will take strong action against illegal cartels and has asked the public's help in this effort. In all likelihood, the burden of the new tax will be shared by consumers and producers, at least over the short run. The higher prices will affect the quantity demanded, with the result that producers will have to shave their markups slightly.

Foreign producers are likely to reap a modest benefit from the tax changes. Imported cars, for example, tend to be luxury models on which taxes will fall significantly. On the export side, the tax will have little effect since the tax will not be assessed against products sold abroad.

Some analysts have suggested that the new tax will prod Japanese wholesalers to consolidate the fragmented distribution system that foreign critics have claimed works as a trade barrier. This is unlikely. Firms might be able to save on paperwork by taking such a step, but the tax is assessed on the value added, not on the gross value of production, at each stage. As a result, eliminating layers of the distribution system would not create a tax saving. Further, the new tax treats small firms more favorably for administrative purposes than it does large firms, so small distribution companies have advantages that offset any additional paperwork burden.

As the American taxpayer approaches the dreaded April income tax deadline, he or she might contemplate the plight of a Japanese counterpart. Just as three years ago the American taxpayer was skeptical when told the income tax system was being reformed in a "revenue-neutral" fashion, the Japanese taxpayer approached April 1, 1989 every bit as cynically, despite the promises of offsetting income and commodity tax relief. A March Nihon Keizai Shimbun survey showed 57 percent of the population opposed to the new consumption tax.

Douglas Ostrom

## Japan's Labor Productivity Outpaces Wage Increases

Explanations of Japan's astonishing economic growth are legion, but one obvious one -- labor productivity -- sometimes is overlooked. Higher output per unit of labor implies that workers can benefit in the form of higher inflation-adjusted wages at the same time their employers enjoy higher profits. The situation generally is even more favorable to employers if the rate of productivity growth exceeds the rate of real wage increase. This pattern, which some economists have identified as a linchpin of Japan's early postwar expansion, has continued in recent years. Between 1975 and 1987 Japan's labor productivity in manufacturing jumped 98 percent, while real wages went up 18.8 percent.

If nominal wage growth is modest relative to productivity gains, unit labor costs are likely to fall, eliminating one source of inflation and making real wage gains more likely. As the table shows, this pattern was evident during earlier years and resumed in recent years. In 1987 and 1988 the growth of

labor productivity exceeded the rate of nominal wage increase by an unusually large amount as the economy recovered from the downturn that hit bottom in late 1986.

Labor Productivity and Wage Gains in Manufacturing, 1975-88

(annual rate of increase)

| | Labor Productivity | Nominal Wages | Real Wages |
|---|---|---|---|
| 1975-80 | 8.6% | 8.3% | 1.7% |
| 1980-84 | 3.9 | 4.2 | 1.3 |
| 1984-85 | 4.4 | 3.1 | 1.0 |
| 1985-86 | 1.8 | 1.5 | 1.1 |
| 1986-87 | 5.8 | 1.7 | 1.9 |
| 1988 January | 12.4 | 3.5 | 2.7 |
| February | 13.8 | 4.3 | 3.7 |
| March | 11.4 | 4.2 | 3.7 |
| April | 12.8 | 4.6 | 4.6 |
| May | 13.8 | 4.2 | 4.2 |
| June | 12.0 | 5.7 | 5.6 |
| July | 10.5 | 3.2 | 2.7 |
| August | 10.9 | 6.0 | 5.4 |
| September | 10.0 | 4.0 | 3.5 |
| October | 12.2 | 4.5 | 3.5 |
| November | 10.3 | 4.4 | 3.2 |
| December (p) | n.a. | 4.9 | 4.0 |

Sources: Japan Productivity Center and Ministry of Labor

As has happened in previous recoveries Japanese firms used their existing labor more productively and were cautious about hiring additional workers in the early phases of the recovery. The resultant boost in overall labor productivity, coupled with wage restraint, helped Japanese firms become more competitive in international markets and offset some of the loss that resulted from the yen's appreciation. As also was true in earlier periods Japanese workers shared in the benefits, with real wage gains in manufacturing coming to 4 percent in December 1988 compared to a year earlier. For all of 1988 real wages in manufacturing rose 4 percent, the biggest increase this decade.

The most recent data show that labor productivity increases in late 1988 remained almost as large as they were earlier in the year and the rate of nominal wage increase almost as small. In short, Japan's tightening labor market (see JEI Report No. 8B, February 24, 1989) has yet to have a significant, damaging impact on the productivity-wage relationship. In fact, the statistics suggest that Japan's unit labor costs in manufacturing continue to fall, implying that the labor market still has a restraining effect on overall prices.

Douglas Ostrom

Rogachev said after meeting with Mr. Uno, can be raised into a tree if both sides show flexibility. Mr. Uno stressed that step-by-step progress was the only way to lay a sound foundation for improved relations. To keep the bud growing, Tokyo has invited five Soviet Foreign Ministry officials for two weeks of talks this fall. It is clear that Japan-Soviet relations are warming up, but rapprochement remains limited by the territorial dispute.

Jon Choy

Wizards Of Ozone Look for Ways To Help LDCs

While not calling for sleight-of-hand substitution or magic, Japan and the United States are looking for ways to help Third World countries bridge a gap brought about by a proposed phaseout of chemicals considered responsible for depleting the ozone layer. Chlorofluorocarbons have helped boost the standard of living in developed nations by acting as coolants in refrigerators and air conditioners and as solvents used in producing semiconductors, among other uses. But scientists have discovered that the long-lived CFCs drift into the upper atmosphere where they end up destroying the ozone layer. This, in turn, permits more harmful ultraviolet light to reach the earth as well as contributes to the greenhouse-like warming of the earth's atmosphere -- with uncertain consequences to agriculture and ocean levels.

A group of more than 30 nations, including Japan and the United States, is moving to combat these bad effects. They have agreed to a United Nations-sponsored 1987 Montreal Protocol to freeze CFC production and consumption at 1986 levels this year and cut them by half that amount by 1998. This year many developed countries urged a ban on the chemicals by 2000. And some countries are pushing harder for an earlier phaseout date, particularly since scientists suggest that current ozone depletion will not hold a candle to the effects produced by more recent, intense use of CFCs.

Early March meetings in London and The Hague, however, have underscored the concerns of Third World countries, which are pressing to gain access to CFC technology before the developed nations begin restricting use of the chemicals. As the developing countries see the problem, the industrial nations have polluted the atmosphere with the long-lasting chemicals and have the jump on coming up with substitutes. To compensate for the development lag, the Montreal Protocol allows the Third World a longer period for phasing out the chemicals. But the suggestion of financial help to developing countries at the early March meetings offered them perhaps a greater hope of being part of the solution to pollution.

The United States already is working independently to help decrease the use of halons, another ozone-depleting substance covered by the Montreal Protocol. An Environmental Protection Agency official noted that a project is under way with the People's Republic of China to develop halon substitutes. Work also is being done with an international institute to find substitutes for the CFCs used in refrigerators, he said. According to the Japan Times, similar coordination might be expected if Japan, the United States and the European Community developed a technology fund for CFC substitutes. "The developing nations insisted that this financing be on top of existing aid and not subtracted from it," the newspaper reported.

Discussions of such financing are expected at a May meeting of environmental officials from both Japan and the United States and at a July meeting in Paris of the Group of Seven industrialized nations. One possibility is a fund to help developing countries license CFC-substitute technology from Japanese and American firms that are developing such alternatives. E.I. DuPont de Nemours & Co., Asahi Glass Co., Ltd. and Seiko Epson Corp. are only some of the companies developing substitutes for either CFC-12, CFC-113 or CFC-11, three of the chemicals covered by the Montreal Protocol. Their willingness to share their technologies may depend in part on whether firms in Third World countries have the funds to pay licensing fees.

Given the longer period for CFC phaseout that the Montreal Protocol extends to developing countries, some experts envision the possibility that the current high production and consumption figures of the industrialized nations will flip-flop over the next decade with the Third World's totals. While figures reportedly are protected with proprietary zeal by manufacturers and thus do not come in neat packages, the Washington-based Chemical Manufacturers Association has broken world CFC consumption shares into: the European Community -- 31 percent; North America -- 30 percent; Japan -- 12 percent; the Soviet Union -- 10 percent; and "others" -- 17 percent. More specific figures from the Alliance for Responsible CFC Policy, a U.S. organization representing the chemicals' manufacturers and users, indicate the United States produces and uses about 29 percent of world CFC totals, while Japan produces about 15 percent and uses about 20 percent of world output.

Chlorofluorocarbon Consumption in Japan by Usage, 1981*

(in tons)

| | |
|---|---|
| Solvents | 56,000 |
| Coolants | 46,000 |
| Foam | 32,000 |
| Aerosols | 13,000 |
| Total | 147,000 |

*Japan's CFC production in 1986 totaled about 187,000 tons. By signing the Montreal Protocol Japan has agreed to halve that number by 1998.

Source: Environment Agency

Leadership in finding air pollution solutions currently appears to be many-sided with leading industrialized nations waving the banners on behalf of improved global climates. Without a coordinated effort, which may include finding and funding ways for developing countries to bridge the technology gap, the leaders may find they have no more impact than the Wizard of Oz.

Pat Murdo

American economic realities and strengths. ATV may be important not only for its direct economic benefits but also as a model for a new mode of interaction between and within government and industry.

Jon Choy

The Bilateral Trade Account: Short-Lived Good News?

For three years economists and policymakers on both sides of the Pacific have been saying that it was just a matter of time before the huge U.S. trade gap with Japan began to narrow since the dollar-yen realignment was moving export and import figures in the right directions. The long-awaited turnaround finally occurred in 1988, but there were few cheers in Washington or Tokyo, for that matter. The reasons are not hard to fathom. For starters, the course correction simply was too limited to produce anything more than a low-key response, especially since it was anticlimactic. After jumping from $10.6 billion in 1979 to $36.8 billion in 1984 and then soaring to $59.8 billion in 1987 (imports valued c.i.f.), the bilateral trade imbalance merely contracted to $55.4 billion last year (see Table 1).

Table 1: U.S. Trade with Japan, 1984-88

(in millions of dollars; exports f.o.b., imports c.i.f.)

| | Exports | Change Over Year-Earlier Period | Imports | Change Over Year-Earlier Period | Trade Balance |
|---|---|---|---|---|---|
| 1984 | $23,575 | 7.7% | $60,371 | 38.6% | $-36,796 |
| 1985 | 22,631 | -4.0 | 72,380 | 19.9 | -49,749 |
| 1986 | 26,882 | 18.8 | 85,457 | 18.1 | -58,575 |
| 1987 | 28,249 | 5.1 | 88,074 | 3.1 | -59,825 |
| 1988 | 37,732 | 33.6 | 93,168 | 5.8 | -55,436 |
| 1986: I | 5,574 | -10.8 | 20,888 | 20.2 | -15,314 |
| II | 7,499 | 41.5 | 20,885 | 13.4 | -13,386 |
| III | 7,229 | 31.1 | 21,555 | 18.3 | -14,326 |
| IV | 6,581 | 18.2 | 22,128 | 20.4 | -15,547 |
| 1987: I | 5,959 | 6.9 | 20,331 | -2.7 | -14,372 |
| II | 6,615 | -11.8 | 21,980 | 5.2 | -15,365 |
| III | 7,644 | 5.7 | 22,228 | 3.1 | -14,584 |
| IV | 8,031 | 22.0 | 23,534 | 6.4 | -15,503 |
| 1988: I | 8,837 | 48.3 | 21,860 | 7.5 | -13,023 |
| II | 9,365 | 41.6 | 22,316 | 1.5 | -12,951 |
| III | 9,741 | 27.4 | 23,011 | 3.5 | -13,270 |
| IV | 9,789 | 21.9 | 25,981 | 10.4 | -16,191 |

Source: Department of Commerce

The modest reduction in the red-ink entry for Japan in 1988 was all the more disturbing because of the big dent made in the overall U.S. trade imbalance. The aggregate deficit, which had climbed five-and-a-half times between 1980 and 1987 to a record $171.2 billion, shrank 20 percent last year to $137.4 billion (imports again c.i.f.). Fully one-third of this improvement reflected a near halving of the deficit with the European Community to $12.8 billion. A smaller shortfall between exports to Taiwan, South Korea, Hong Kong and Singapore and imports from these newly industrialized economies (down from $37.7 billion in 1987 to $31.6 billion last year) also had more of an impact on the U.S. trade account than the narrower gap with Japan. The same was true in relative terms of this country's trade results with the members of the Organization of Petroleum Exporting Countries as the imbalance shrank by $3.6 billion to $11.1 billion. In fact, only the slight change in the bottom line with Canada in 1988 -- a deficit of $10.6 billion replacing one of $11.7 billion -- made the U.S.-Japan trade results look good.

The underlying numbers were cause for some satisfaction, however. Pushed by the dollar's roughly 50 percent drop against the yen over the last three years and pulled by the strong expansion of domestic demand, U.S. exports to Japan soared 33.6 percent in 1988 to $37.7 billion. Growth was broad-based (see Table 2), extending from the old mainstay of American shipments -- industrial and agricultural inputs -- to the new sales leader, manufactured products, which accounted for more than one-half of exports to Japan for the second year running. At the same time, the dollar-yen shift and the performance of the American economy again reined in the rise in U.S. imports from Japan. Purchases increased by a modest 5.8 percent to $93.2 billion on a c.i.f. basis, in part because cars and trucks were added to the list of major made-in-Japan products in the minus or slow-growth column (see Table 3).

What worries private-sector and government analysts alike is that these developments produced a one-time improvement -- and a small one at that -- in the U.S.-Japan trade picture. In this scenario the jump in red ink during the October-December 1988 period cannot be written off as a quirk. Instead, it is a sign that, short of a prolonged recession in this country and a sustained boom in Japan, the bilateral deficit is headed back toward its record 1987 level after just three quarters of progress.

Susan MacKnight

Notes

Stopgap Budget - Continuing political trouble over the Recruit Co., Ltd. influence-buying affair makes it unlikely that Prime Minister Noboru Takeshita will be able to push the 1989 budget through the Diet before the April 1 start of the fiscal year. The government has been forced to compile a temporary budget of Y10 trillion ($80 billion at Y125=$1.00) for the first 50 days of the fiscal year, but opposition party resistance to passing even this temporary measure is strong.

Opposition parties are demanding that former Prime Minister Yasuhiro Nakasone testify about his involvement in the Recruit affair before the Diet. Prime Minister Takeshita's reluctance to call on his predecessor has sparked

Table 2: U.S. Exports to Japan, 1987-88

(in millions of dollars, f.a.s. value)

| | 1987 | 1988 | Percent Change |
|---|---|---|---|
| Total Exports | $28,248.6 | $37,732.1 | 33.6% |
| Industrial Supplies | 10,247.0 | 12,951.4 | 26.4 |
| Bituminous Coal | 484.5 | 597.5 | 23.3 |
| Petroleum Products | 661.3 | 657.9 | -0.5 |
| Logs and Lumber | 1,573.4 | 1,906.2 | 21.2 |
| Paper Base Stocks | 756.7 | 1,051.5 | 39.0 |
| Paper and Paper Products | 404.1 | 476.6 | 17.9 |
| Organic Chemicals | 870.4 | 1,105.6 | 27.0 |
| Inorganic Chemicals | 831.5 | 887.7 | 6.8 |
| Plastics and Synthetic Resin Compounds | 422.8 | 544.4 | 28.8 |
| Nonferrous Ores and Scrap | 553.9 | 892.7 | 61.2 |
| Nonferrous Metals | 394.3 | 826.3 | 109.6 |
| Raw Cotton | 413.7 | 484.0 | 17.0 |
| Hides and Skins | 369.6 | 465.0 | 25.8 |
| Capital Goods | 7,290.4 | 10,059.9 | 38.0 |
| Electric Machinery | 471.2 | 629.3 | 33.5 |
| Nonelectric Machinery | 4,873.2 | 7,103.0 | 45.8 |
| Industrial and Service Machinery | 1,602.4 | 2,453.1 | 53.1 |
| Computers, Peripherals and Semiconductors | 2,038.8 | 2,976.9 | 46.0 |
| Telecommunications Equipment | 418.9 | 585.8 | 39.8 |
| Scientific and Medical Equipment | 557.2 | 747.6 | 34.2 |
| Transportation Equipment | 1,945.9 | 2,327.7 | 19.6 |
| Civilian Aircraft | 1,094.9 | 1,288.8 | 17.7 |
| Civilian Aircraft Parts | 796.0 | 854.6 | 7.4 |
| Food, Feed and Beverages | 5,578.9 | 7,964.2 | 42.8 |
| Corn | 1,036.0 | 1,616.2 | 56.0 |
| Soybeans | 785.7 | 1,030.1 | 31.1 |
| Wheat | 352.3 | 425.5 | 20.8 |
| Fruits and Vegetables | 664.5 | 822.1 | 23.7 |
| Meat and Meat Products | 898.3 | 1,375.4 | 53.1 |
| Fish and Fish Products | 1,058.8 | 1,576.4 | 48.9 |
| Consumer Goods | 2,548.0 | 3,273.0 | 28.5 |
| Nondurables | 1,612.5 | 1,944.4 | 20.6 |
| Pharmaceuticals | 679.7 | 784.8 | 15.5 |
| Cigarettes | 491.9 | 606.3 | 23.3 |
| Durables | 783.1 | 1,112.5 | 42.1 |
| Recreational Equipment | 256.7 | 390.5 | 48.2 |
| Gems, Jewelry and Collectibles | 244.0 | 326.6 | 33.8 |
| Automotive Products | 361.8 | 776.7 | 114.7 |
| Automotive Parts, Engines, Bodies and Chassis | 253.4 | 417.4 | 64.7 |
| Other Exports | 2,222.5 | 2,706.8 | 21.8 |

Source: Department of Commerce

Table 3: U.S. Imports from Japan, 1987-88

(in millions of dollars, Customs value)

| | 1987 | 1988 | Percent Change |
|---|---|---|---|
| Total Imports | $84,575.0 | $89,802.1 | 6.2% |
| Capital Goods | 27,576.6 | 32,823.8 | 19.0 |
| Electric Machinery | 2,937.4 | 3,566.0 | 21.4 |
| Nonelectric Machinery | 24,120.7 | 28,701.9 | 19.0 |
| Construction, Mining and Drilling Equipment | 1,079.2 | 1,376.1 | 27.5 |
| Industrial and Service Machinery | 7,230.3 | 8,465.3 | 17.1 |
| Agricultural Machinery | 550.4 | 494.0 | -10.2 |
| Computers, Peripherals and Semiconductors | 8,341.6 | 11,058.0 | 32.6 |
| Other Business Machines | 2,414.0 | 2,458.4 | 1.8 |
| Telecommunications Equipment | 3,640.5 | 3,867.7 | 6.2 |
| Scientific and Medical Equipment | 864.8 | 982.3 | 13.6 |
| Transportation Equipment | 518.5 | 555.9 | 7.2 |
| Civilian Aircraft, Engines and Parts | 303.6 | 405.4 | 33.5 |
| Automotive Products | 33,733.5 | 32,765.1 | -2.9 |
| Cars | 21,306.6 | 19,879.9 | -6.7 |
| Trucks and Special-Purpose Vehicles | ,961.2 | 3,733.7 | -24.7 |
| Automotive Parts, Engines, Bodies and Chassis | 7,465.8 | 9,151.6 | 22.6 |
| Consumer Goods | 13,946.7 | 14,252.2 | 2.2 |
| Nondurables | 1,396.6 | 1,452.7 | 4.0 |
| Apparel, Footwear and Household Goods | 455.8 | 364.9 | -19.9 |
| Durables | 12,410.7 | 12,638.7 | 1.8 |
| Household Goods | 1,938.8 | 1,788.7 | -7.7 |
| Recreational Equipment | 3,434.6 | 4,201.3 | 22.3 |
| Home Entertainment Equipment | 6,448.5 | 6,046.2 | -6.2 |
| Video and Audio Recorders and Players and Stereo Equipment | 4,068.8 | 3,563.6 | -12.4 |
| Gems, Jewelry and Collectibles | 588.8 | 602.6 | 2.3 |
| Intermediate Goods | 8,046.4 | 8,585.0 | 6.7 |
| Steel Mill Products | 2,214.7 | 2,666.1 | 20.4 |
| Nonferrous Metals | 450.6 | 414.5 | -8.0 |
| Organic Chemicals | 846.9 | 887.2 | 4.8 |
| Textiles | 755.5 | 675.0 | -10.7 |
| Food, Feed and Beverages | 458.8 | 396.0 | -14.7 |
| Other Imports | 813.0 | 980.0 | 20.5 |

Source: Department of Commerce

even stronger calls by opposing Diet members for Mr. Nakasone to testify. In order to prevent a cutoff of vital government services and subsidies, opposition parties agreed March 16 to let action proceed on 17 spending measures, including the stopgap budget. Even then, however, opposition parties agreed to vote on only 16 of the 17 bills. The disputed one, which covers various government subsidies, is set to be debated April 3-6. A showdown over whether Mr. Nakasone will testify is expected April 7.

Trade Task Force - Speaker of the House James Wright (D, Tex.) announced March 22 the selection of Rep. Richard Gephardt (D, Mo.) to chair the newly created Trade and Competitiveness Task Force. The task force will add another layer in Washington to those who are more closely scrutinizing American economic policies. Announcements about the new group state that it will "coordinate efforts" in the House that affect the trade position of the United States. The task force also is planning to track implementation of the Omnibus Trade and Competitiveness Act of 1988 in addition to those committees and subcommittees already responsible for oversight. Among other key items on the task force agenda is evaluation of the possible economic impact on the United States of high-definition television and the European Community's 1992 integration measures.

The new task force is comprised of 26 Democrats, including Rep. John Bryant (Tex.). A vote on a bill sponsored by Mr. Bryant (HR 5), which seeks registration of information regarding foreign direct investment in the United States, has been postponed possibly until May, Capitol Hill staffers say.

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.